

Pelorus Navigation Systems Inc.

Annual Report 1997



near Business Reference Lib
University of Alberta
8 Business Building
Edmonton, Alberta T6G 2R6

Ship's Pelorus circa 1900

PELORUS NAVIGATION SYSTEMS INC.

Our mission is to provide products to facilitate safe, reliable landings for aircraft.

*We design, manufacture, install and maintain navigational equipment.
In January 1995, we teamed with Honeywell Inc. of the United States to design, manufacture,
install and maintain a Satellite Landing System for use in precision approach and landing.
In our 15 year history, we have installed navigation equipment on six continents,
both on and offshore.*

*In August 1997, the Honeywell/Pelorus Satellite Landing System became the
world's first Differential Global Positioning System ground station
to receive Federal Aviation Administration Type Acceptance certification.*

*Our head office is located at Calgary, Alberta with production and
engineering facilities located at Calgary and Saskatoon, Saskatchewan.*

*Pelorus is a public company with shares listed on
the Alberta Stock Exchange under the symbol "PN".*

FINANCIALS

	May 31, 1997 12 months	May 31, 1996 12 months
Revenue	\$ 817,087	\$ 2,149,971
Net Income (Loss)	\$ (1,367,237)	\$ 122,690
Net earnings per share	\$ (0.19)	\$ 0.03
Capital expenditures	\$ 673,778	\$ 489,966
Cash and equivalents	\$ 1,457,001	\$ 1,020,905
Current ratio ⁽¹⁾	6.7:1	2.7:1
Number of shares outstanding	7,678,680	6,640,013
Annual share prices high-low	\$ 8.60 – 4.50	\$ 9.00 – 0.60

⁽¹⁾ Current assets divided by current liabilities

ACCOMPLISHMENTS

- Makes aviation history with world's first Satellite Landing System to receive Type Acceptance certification from the Federal Aviation Administration.
- Installs Satellite Landing Systems at airports in Canada, the United States and Australia.
- Delivers Satellite Landing Systems to NASA for Space Shuttle training.
- Expands plant capacity to meet market demand for Satellite Landing Systems.
- Launches international program to install Satellite Landing Systems in support of Honeywell's marketing program.
- Penetrates market in Peoples Republic of China with sale of Distance Measuring Equipment.

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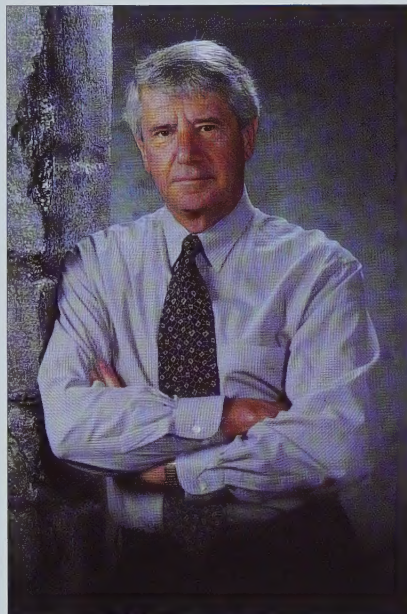
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LETTER TO THE SHAREHOLDERS

Certification of the Honeywell/Pelorus Satellite Landing System (SLS) culminated four years of intensive effort and represents a major milestone in our Company's development.

In August 1997, the Honeywell/Pelorus SLS became the world's first Differential Global Positioning System (DGPS) ground station to receive Federal Aviation Administration (FAA) Type Acceptance certification. The FAA's acceptance demonstrates our ability to apply DGPS-based technology to practical uses that will increase operating efficiency and safety at airports worldwide.

This accomplishment is attributable to the tenacity, skill and ingenuity of our people whose commitment to excellence and to finishing first is unqualified. We also are privileged to be associated with the Honeywell Corporation, with whom we signed a teaming agreement in January 1995 to design, manufacture, install and maintain Satellite Landing Systems. Honeywell led the charge to obtain FAA Type Acceptance.



During the year, in preparation for Type Acceptance, we focused on developing our capability to commercialize the Honeywell/Pelorus SLS. In October 1996, we successfully

completed a \$3,600,000 equity issue by way of a private placement of 600,000 common shares at \$6.00 per share. Proceeds from the issue were used to conclude the FAA certification process, to strengthen our management team, introduce a responsive company wide information system, expand our facilities in Saskatoon and Calgary to provide production capacity of 200 SLS annually, to enhance our marketing effort and to provide additional working capital to meet future growth needs.

According to the U.S. government, there are about 48,000 airports in the world with runways over 3,500 feet. All are candidates for our SLS. The Honeywell/Pelorus strategy is to get systems into every key market worldwide. Honeywell has the lead responsibility for marketing in our Teaming Agreement and is working vigorously with a comprehensive program of trade shows,

exhibits, and flight demonstrations through its organization of sales offices around the globe. Our responsibility at Pelorus, in addition to manufacturing, testing and engineering is to provide international installation capability and user training in support of Honeywell's marketing program. The Honeywell/Pelorus SLS was selected for installation by the Metropolitan Airport Commission for use at the Minneapolis/St. Paul International Airport. The system has been operating since April 1996. Most of the Satellite Landing System test and validation flights on the Honeywell Citation V were flown at this site.

The Honeywell/Pelorus SLS was also selected by Continental Airlines and the Port Authority of New York and New Jersey at Newark International Airport in a program sponsored by the Air Transport Association. The data collected during Project Newark will be used by the FAA as the baseline for future certification processes for precision approaches, benefiting other air carriers as well as general aviation. Continental Airlines has applied for operational approval at Newark and is anticipating it late this year.

In Canada, the Honeywell/Pelorus SLS is installed at Regina Airport and Saskatoon Airport where operational approval by Transport Canada is expected this fall. As well, two Honeywell/Pelorus SLS were purchased by NASA for use with its Space Shuttle training aircraft at Cape Canaveral, Florida and White Sands, New Mexico.

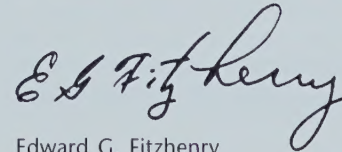
In April of 1997, we installed a Honeywell/Pelorus SLS at Melbourne Airport, Victoria, Australia for use by Airservices Australia to develop precision approach and landing standards for Australia.

Other planned installation sites include Australia, Brazil, Canada, Russia and the United States, with sales pending in several other countries.

In addition to our SLS initiative, we continue to market our Distance Measuring Equipment (DME). This year, we delivered DME's to customers in China and Korea. We also continue to explore acquisition opportunities to further strengthen our capacity to meet the growth activity planned for the Honeywell/Pelorus SLS and to expand our product line.

People at Pelorus are long-term thinkers; we see trends and invest in them. We thank our investors for sharing our vision and for their patience as we look forward to a future of steady, sustained growth and profitability.

On behalf of the Board of Directors,

A handwritten signature in dark ink, appearing to read "E. G. Fitzhenry". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

Edward G. Fitzhenry
Chairman and Chief Executive Officer

DIFFERENTIAL GPS PRECISION APPROACH

Differential Global Positioning Systems (GPS) are today's solution to affordable precision approach for aircraft. Using freely available satellite-based navigation signals and a correction signal from the Honeywell/Pelorus Satellite Landing System (SLS) ground station, aircraft are able to fly runway approaches with both horizontal and vertical guidance, providing pilots with increased positional awareness for safer, smoother, and more expeditious approaches and landings.

A precision approach increases pilot awareness, lowers workload and provides for safer landings than a non-precision approach. A precision approach provides the pilot with a smooth descent down a glide-path, to a decision point at which the pilot proceeds to land or executes a missed approach. A non-precision approach, however, requires the pilot to descend, level the aircraft, descend again and level the aircraft, with perhaps another repetition before reaching a decision point for landing, at which point another descent will have to begin. Non-precision approaches require pilots to reference several cockpit instruments to determine altitude, time, and distance to the runway, without the benefit of vertical guidance; all the while tolerating higher landing limits than precision approaches.

If non-precision approaches increase pilot workload and result in more missed approaches, why then do they

exist? Well, the current generation of precision approach aids are expensive and may, in some cases, be impossible to install due to terrain or radio interference. Further, current precision approach aids such as the Instrument Landing System (ILS) and the Microwave Landing System (MLS) service only one runway end per ground equipment set.

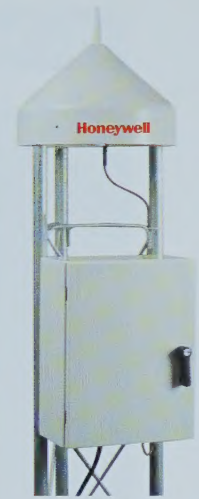
To outfit an airport such as Calgary International with traditional precision approach aids for each runway end would require six ILS or MLS units; such a cost is prohibitive for any but the world's busiest airports. One Honeywell/Pelorus SLS, on the other hand, will provide precision approach information to all runway ends for airports within 20 to 30 nautical miles of the ground station transmitter, at a fraction of the cost of a single ILS or MLS. In addition to capital savings, maintenance costs for the Honeywell/Pelorus SLS are well below those for existing precision approach aids.

Differential GPS Approaches

Differential GPS approaches compare the known location of the receivers with position information derived from GPS satellites. Differences between the two positions are resolved and transmitted to aircraft on approach, providing them with a correction to their "raw" GPS position information. Further, the SLS identifies malfunctioning satellites having invalid information and instructs aircraft to exclude such satellites from their computations. The end result is an aircraft on approach with horizontal and vertical guidance information accurate to 1.5 and 2 metres, respectively, greatly reducing the risk of accident and increasing the number of successful approaches and landings.

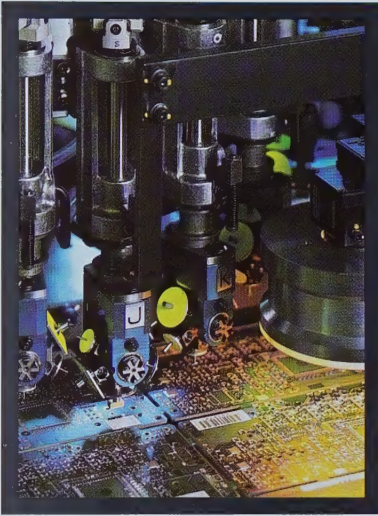


The Honeywell/Pelorus Satellite Landing System (SLS) processes data from the GPS satellites, validates the information, calculates differential corrections, and transmits the corrected information and approach data to aircraft within 20 to 30 nautical miles of the airport. The SLS continually monitors its own status, reporting maintenance requirements to control authorities. The SLS is designed with fault-tolerant redundant architecture, allowing for continuous safe and reliable operation even while awaiting repair and maintenance.



The Remote Satellite Measurement Unit (RSMU) receives and processes raw GPS satellite data. The GPS information from the RSMU's is sent via landline to the SLS for differential and integrity processing.

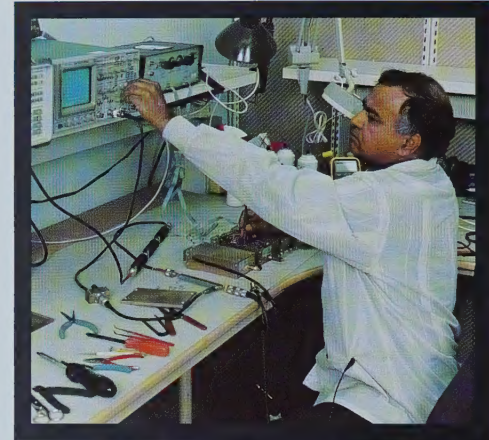
PELORUS OPERATIONS



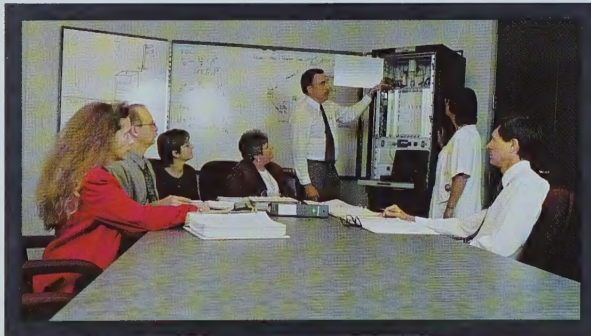
Pelorus utilizes robotic component placement equipment which enhances our manufacturing processes and produces a superior product for our customers.



Quality Assurance is an integral element in the assembly and manufacture of all Pelorus products.



Our commitment to our customers goes beyond design and manufacture, to warranty and long-term product support.



Pelorus engineers provide operation and maintenance instruction to navigation aid customers from around the world.



To ensure the proper functioning of its equipment, Pelorus provides installation services as well. We have installations on 6 continents at over 150 sites, most recently in Australia.



Courtesy Aircivics Bulletin (Australia)

Honeywell/Pelorus Satellite Landing System

World's First FAA Type Approved Differential GPS
Precision Approach and Landing System ...
In use today around the world.



Australia: Melbourne, Victoria.



Canada: Saskatoon and Regina, Saskatchewan.



United States: Minneapolis/St. Paul, Minnesota
and Newark, New Jersey.



Honeywell/Pelorus SLS 2000



NASA: White Sands, New Mexico and
Kennedy Space Center, Florida.

Courtesy NASA

PELORUS HISTORY

- 
- 1983 • Pelorus startup as airport navigation aid equipment distributor.
 - 1984 • Marketing network development within Canada.
 - 1985 • Opens manufacturing facility in Calgary.
 - 1986 • Supplies and installs Canada's first Microwave Landing System and fully Automated Weather Observation and Reporting System for airports.
 - 1987 • Pelorus becomes a public company.
 - 1988 • Acquires assets and technology of European aerospace company and expands sales into Europe.
 - 1989 • Pioneers adoption of Distance Measuring Equipment for helicopter operation on ice breakers and oil rigs.
 - 1990 • Expands sales into Asia and Australia.
 - 1991 • Develops state-of-the-art Distance Measuring Equipment for landing and enroute navigation.
 - 1992 • Develops air traffic control system simulator for Transport Canada, with nation-wide installations.
 - 1993 • Introduces prototype satellite navigation system.
 - 1994 • Expands into South America with sale of Distance Measuring Equipment to Argentina.
 - 1995 • Signs teaming agreement with Honeywell Inc. to develop, manufacture, install and market the Satellite Landing System (SLS).
 - Sells world's first satellite landing systems for installation in Canada, Australia and the United States.
 - 1996 • Establishes factory in Saskatoon for production of the Honeywell/Pelorus SLS to supply world markets.
 - SLS selected by Russian Department of Transportation for development of a GPS/GLONASS landing system.
 - 1997 • SLS receives Federal Aviation Administration Type Approval.
 - Expands into China with sale of two Distance Measuring Equipment systems.
 - Installs SLS in Melbourne — Australia's first GPS precision approach landing aid.
 - Delivers two SLS to NASA for Space Shuttle training.

Financial Section

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MANAGEMENT DISCUSSION AND ANALYSIS

Results of Operations

Revenue

Deliveries of DME to Korea and China accounted for most of the revenue of \$817,087 for 1997. The decrease of \$1,332,884 from 1996 reflects declining demand in domestic markets for conventional navigational systems as airport operators await the implementation of satellite-based technology.

We did not recognize all revenue associated with manufacturing Satellite Landing Systems since certain individual sales contracts were conditional pending certification of the product.

Operating and Administrative Expense

There are two components of Operating and Administrative Expense — cost of goods sold and administration.

Cost of goods sold in 1997 was lower than in 1996, reflective of lower 1997 revenues. Gross operating margins in 1997 were consistent with prior years.

Administrative expenses in 1997 increased over 1996 as we strengthened our management team and internal processes to prepare for the growth planned in the international commercialization of the SLS.

Selling Expense

Selling expenses increased by 15% to \$180,434 as a result of increased marketing efforts on behalf of the SLS in Canada. Marketing expenses for DME were reduced in response to declining demand for conventional navigation systems as the market anticipates adoption of satellite based systems.

Product Development Costs

During 1997, we invested \$1,553,016 in product development of the SLS. The costs related primarily to engineering, testing and documentation required to support the Federal Aviation Administration Type Acceptance certification process. In accordance with Company policy, we deferred these costs pending certification.

Net Income

The combination of lower revenue and higher administration costs as discussed above contributed to a loss for the year of \$1,367,237.

Liquidity and Capital Resources

Our cash position improved in 1997 as a result of a private placement of 600,000 shares and warrants and the exercise of options, providing net proceeds of \$4,077,369. Cash flow from operations was \$(1,187,972).

At May 31, 1997 cash and equivalents were \$1,457,001, with no corresponding bank indebtedness. Net working capital was \$2,833,631, up from \$2,231,302 in 1996, representing a working capital ratio of 6.7 to 1. In 1996 the working capital ratio was 2.7 to 1.

Proceeds from the private placement in October, 1996, were used primarily to fund SLS product development and working capital requirements.

Capital assets increased by \$484,200, principally through purchase of test equipment for SLS production, leasehold improvements and addition of a computer network.

Accounts payable decreased substantially to \$146,382 as a result of SLS production scheduling.

Non-operating expenditures include the repayment of short-term debt of \$427,500 to related parties.

Credit Facilities and Debt Obligations

The Company maintains an \$800,000 working capital credit facility with Alberta Treasury Branches. There was no requirement to use the above facility in 1997. As a result of SLS contract prepayments, there continues to be \$250,000 in unrecognized revenue. It is expected that the terms of this contract will be fulfilled in 1998.

At May 31, 1997, long term debt stood at \$530,033, down from \$600,620 in 1996.

Share Capital

In October of 1996, the Company completed a private placement of 600,000 units at \$6.00 per unit, for gross proceeds of \$3,600,000. A further \$699,266 was raised on the exercise of options to acquire stock. 10,000 shares were issued in exchange for services rendered by external parties.

At 31 May, 1997, there were 7,678,680 shares issued and outstanding. Employee and director options to acquire an additional 522,300 shares on or before dates to May, 2002, are outstanding.

Risk Factors and Considerations

Market Size

While Type Acceptance certification by the Federal Aviation Administration of the Honeywell/Pelorus SLS 2000 is an important development in the implementation of Differential Global Positioning System (DGPS) ground stations for precision approach and landing, the technology is, as yet, not an international standard. To become an international standard, the technology requires endorsement by the International Civil Aviation Organization (ICAO), a body of 185 member nations.

On operational and economic grounds, the case for a worldwide satellite-based navigational network is compelling. There are however, political and other considerations in the universal adoption of a DGPS-based navigational system. Pelorus and its teaming partner, Honeywell, are working diligently on relevant industry committees to provide test data and analysis on the use and performance of DGPS ground station technology. Adoption of DGPS by ICAO as a precision approach and landing standard is a qualifying factor in the ultimate size of the market for DGPS ground stations such as the Honeywell/Pelorus SLS.

Market Timing

Operational use of the Honeywell/Pelorus SLS requires that aircraft are equipped with appropriate DGPS avionics. Currently, the avionics that are commercially available are suitable for the latest generation of digital cockpit aircraft. Avionics that are priced and configured to meet the specific requirements of general aviation and regional commercial carrier operators are under development but not yet on the market. Wide scale adoption of DGPS and sales of the Honeywell/Pelorus SLS may be conditioned by the timing of the availability of suitable avionics for the general aviation and regional carrier aircraft operators. Honeywell and Pelorus are collaborating with avionics manufacturers to encourage an accelerated introduction of DGPS airborne solutions for all aircraft types that use precision approach and landing systems.

Product Development

The Honeywell/Pelorus SLS has been Type Approved by the Federal Aviation Administration as meeting the specification for Special Category I (SCAT I) precision approach and landing. While we believe that SCAT I will be the basis for the universal standard, the standard may change and, therefore, necessitate an investment in further development, testing and regulatory approval of the SLS.

Honeywell Relationship

Global adoption of a new technology such as the SLS, requires a marketing effort well beyond the capacity of Pelorus' resources. Commercial success of the SLS is dependent on Honeywell's effectiveness and on Honeywell's continued commitment to the Honeywell/Pelorus program. Federal Aviation Administration certification of the Honeywell/Pelorus SLS 2000 in August of 1997 is a testament to the solid alliance forged between the two companies in January of 1995. We are intent on performing our obligations under the Honeywell/Pelorus Teaming Agreement and doing what it takes within our capacity to support the SLS program and Honeywell's international marketing effort.

AUDITORS' REPORT

To the Shareholders of Pelorus Navigation Systems Inc.

We have audited the balance sheets of Pelorus Navigation Systems Inc. as at May 31, 1997 and 1996 and the statements of income and deficit and changes in financial position for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at May 31, 1997 and 1996 and the results of its operations and the changes in its financial position for the years then ended in accordance with generally accepted accounting principles.



Chartered Accountants

Calgary, Alberta
July 15, 1997

BALANCE SHEETS

Assets

May 31	1997	1996
Current		
Cash and term deposits	\$ 1,457,001	\$ 1,020,905
Accounts receivable	783,463	1,548,539
Inventory (note 2)	1,063,881	951,665
Prepaid expenses	27,668	17,368
	<u>3,332,013</u>	<u>3,538,477</u>
Deferred product development costs (note 3)	3,007,950	1,454,934
Capital assets (note 4)	1,243,513	759,313
Investment tax credits recoverable (note 10)	529,481	529,481
	<u>\$ 8,112,957</u>	<u>\$ 6,282,205</u>

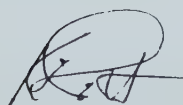
Liabilities and Shareholder's Equity

	1997	1996
Current		
Accounts payable	\$ 146,382	\$ 527,675
Deferred revenue	250,000	250,000
Due to related parties (note 6)	—	427,500
Current portion of long-term debt	102,000	102,000
	<u>498,382</u>	<u>1,307,175</u>
Long-term debt (note 7)	428,033	498,620
	<u>926,415</u>	<u>1,805,795</u>
Share capital (note 8)	9,844,308	5,766,939
Contributed surplus (note 8(d))	356,808	356,808
Deficit	(3,014,574)	(1,647,337)
	<u>7,186,542</u>	<u>4,476,410</u>
	<u>\$ 8,112,957</u>	<u>\$ 6,282,205</u>

On behalf of the Board:



E.G. Fitzhenry
CEO and Chairman of the Board



Director

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF INCOME AND DEFICIT

For the years ended May 31	1997	1996
Revenue		
Contract sales and services	\$ 774,852	\$ 2,139,870
Other	42,235	10,101
	<u>817,087</u>	<u>2,149,971</u>
 Operating and administrative expenses	 1,796,712	 1,793,005
Selling expenses	180,434	156,650
Interest on long term debt	27,913	6,099
	<u>2,005,059</u>	<u>1,955,754</u>
 Income (loss) before the undernoted	 (1,187,972)	 194,217
 Amortization	 179,265	 71,527
Income (loss) before taxes	<u>(1,367,237)</u>	<u>122,690</u>
Income taxes (recovery)		
Current	-	58,059
Utilization of loss carryforward balance	-	(58,059)
	<u>-</u>	<u>-</u>
 Net income (loss) for the year	 <u>\$ (1,367,237)</u>	 <u>\$ 122,690</u>
 Earnings per share (note 9)		
Basic	\$ (0.19)	\$ 0.03
Fully diluted	\$ (0.19)	\$ 0.03

	1997	1996
Deficit, beginning of year	\$ (1,647,337)	\$ (1,770,027)
Net income (loss) for the year	(1,367,237)	122,690
 Deficit, end of year	 <u>\$ (3,014,574)</u>	 <u>\$ (1,647,337)</u>

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF CHANGES IN FINANCIAL POSITION

For the years ended May 31	1997	1996
Cash provided (used) by		
Operating Activities		
Operations		
Net income (loss) for the year	\$ (1,367,237)	\$ 122,690
Items not involving cash		
Amortization	179,265	71,527
	(1,187,972)	194,217
Changes in non-cash working capital balances		
Accounts receivable	765,076	(824,494)
Inventory	(112,216)	(316,461)
Prepaid expenses	(10,300)	10,608
Due to related parties	(427,500)	427,500
Accounts payable	(381,292)	213,317
Deferred revenue	-	199,925
	(1,354,204)	(95,388)

	1997	1996
Financing Activities		
Increase (decrease) in long-term debt	\$ (70,587)	\$ (10,000)
Issue of share capital, net	4,077,369	3,516,450
Repurchase of preferred shares (note 8(d))	-	(400,000)
	4,006,782	3,106,450
Investing Activities		
Purchase of capital assets	(673,778)	(489,966)
Increase in deferred development costs	(1,553,016)	(1,134,486)
Proceeds on disposal of capital assets	10,312	-
	(2,216,482)	(1,624,452)
Increase in cash and equivalents	436,096	1,386,610
Cash (bank indebtedness), beginning of year	1,020,905	(365,705)
Cash and equivalents, end of year	\$ 1,457,001	\$ 1,020,905

Cash and equivalents represented by:		
Cash	\$ 452,233	\$ 470,905
Term deposits	1,004,768	550,000
	\$ 1,457,001	\$ 1,020,905

The accompanying notes are an integral part of these financial statements.

NOTES TO FINANCIAL STATEMENTS

May 31, 1997 and 1996

1. Significant Accounting Policies

The following is a summary of significant accounting policies of the Company:

(a) Revenue recognition

The Company recognizes revenue on manufacturing and installation contracts on the percentage of completion method. Percentage of completion is determined either as the proportion of costs incurred to expected contract costs, or is based on the percentage of labour to total expected labour costs. In applying the percentage of completion method, management evaluates each contract to determine the basis that best reflects the stage of completion for the particular contract. Included in accounts receivable are unbilled amounts of \$169,000 (1996 - \$851,832).

As at June 30, 1997 and 1996, the revenue on certain manufacturing contracts in progress have not been recognized as the individual sales are conditional upon pending certification of the product.

(b) Inventory

Inventory is recorded at the lower of cost and replacement value, which is not in excess of net realizable value. Cost is generally determined on a first-in, first-out basis.

(c) Capital assets

Capital assets are recorded at cost, net of related investment tax credits.

Amortization is provided on assets in use during the year on the following basis:

Machinery and equipment	– 15% declining balance basis
Furniture and fixtures	– 20% declining balance basis
Automotive	– 30% declining balance basis
Leasehold improvements	– 17% straight line basis

(d) Foreign currency translation

Foreign currency accounts are translated to Canadian dollars as follows:

At the transaction date, each asset, liability, revenue or expense is translated into Canadian dollars by the use of the exchange rate in effect at that date. At the year end date, monetary assets and liabilities are translated into Canadian dollars by using the exchange rate in effect at that date and the resulting foreign exchange gains and losses are included in income in the current period.

(e) Deferred product development costs

Product design and development costs in relation to the development of new products are deferred and capitalized net of investment tax credits claimed, if such credits are reasonably expected to be utilized. These costs include design costs, direct materials, wages and other overhead attributable to the development of new products. These costs are currently not being amortized. Amortization will commence upon commercial production and/or other certifications of new products. These deferred costs will be amortized on a unit of production basis over a period not to exceed five years.

If the project is cancelled and judged to be non-commercially viable, all deferred development costs will be expensed in the year of cancellation.

Research costs of a general nature are expensed during the year, net of related investment tax credits claimed, if such credits are reasonably expected to be utilized. See Note 1(f).

(f) Investment tax credits

Investment tax credits are recorded in the year they are earned provided there is reasonable assurance that the credits will be realized.

(g) Financial instruments

The Company's financial instruments consist of cash, accounts receivable, prepaids, accounts payable, and long-term debt. Unless otherwise indicated, it is management's opinion that the Company is not exposed to significant interest rate, foreign currency rate, or credit risks arising from these financial instruments. The fair values of these financial instruments approximates their carrying values, unless otherwise noted.

(h) Accounting estimates

The Company defers certain costs incurred on manufacturing contracts underway as work in progress inventory. These amounts are based on standard cost estimates for their material and labour components. Management has deferred these costs based on their best estimate given information currently available. Substantially all of the work in progress inventory on hand at May 31, 1997 relates to the contracts for sale of satellite landing systems. As there is limited manufacturing history with regards to these new systems, the nature and amount of these estimates are subject to measurement uncertainty and actual results could differ from these estimates.

2. Inventory

Raw materials
Work in progress

	<u>1997</u>	<u>1996</u>
Raw materials	\$ 267,410	\$ 338,743
Work in progress	796,471	612,922
	<u>\$ 1,063,881</u>	<u>\$ 951,665</u>

NOTES TO FINANCIAL STATEMENTS

3. Deferred Product Development Costs

The Company has deferred product design and development costs including direct labour, materials and other general and administrative overhead attributable to the development of the new generation satellite landing system. The costs deferred include:

	1997	1996
Design costs	\$ 1,282,280	\$ 645,346
Labour	696,765	311,790
Material	692,930	283,650
Other overhead	300,822	178,995
Interest and financing	35,153	35,153
	<u>\$ 3,007,950</u>	<u>\$ 1,454,934</u>

4. Capital Assets

	1997		1996	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Machinery and equipment	\$ 1,264,657	\$ 536,319	\$ 1,031,958	\$ 421,176
Furniture and fixtures	689,677	277,537	342,202	225,014
Automotive	36,931	22,550	19,224	17,757
Leasehold improvements	162,551	73,897	79,629	49,753
	<u>2,153,816</u>	<u>910,303</u>	<u>1,473,013</u>	<u>713,700</u>
Cost less accumulated amortization		<u>\$ 1,243,513</u>		<u>\$ 759,313</u>

5. Bank Indebtedness

The Company has an operating line of credit of \$800,000, advances of which are due on demand and which bears interest at prime plus 1%. Bank loans are supported by a general security agreement.

6. Due to Related Parties

During 1996, the Company received advances from certain directors who are also shareholders and key members of the management team, in the amount of \$427,500. The balance was unsecured, payable on demand and bore interest at prime plus 2% per annum. During 1997, the Company repaid these advances (see Note 12).

7. Long-term Debt

	<u>1997</u>	<u>1996</u>
Government of Alberta unsecured note, repayable in monthly installments of \$3,500, beginning July 31, 1996. In addition, the Company will pay 2.5% of gross revenue for a year after the principal is repaid, to a maximum of \$45,000.	\$ 21,064	\$ 70,283
Government of Alberta unsecured note, interest compounding at 10% per annum since March 31, 1995, repayable in monthly installments of \$3,500, beginning December 31, 1997 with interest at 10% per annum with total repayment not to exceed \$75,000.	73,832	67,101
Western Diversification unsecured program loan, repayable in \$5,000 monthly installments and quarterly installments of 6% of gross revenues in excess of \$1,000,000 to May 31, 1998. The loan bears interest effective April 1, 1996 at 8.25%. All remaining principal and interest outstanding is due June 30, 1998.	435,137	463,236
	530,033	600,620
Less current portion	(102,000)	(102,000)
	<u>\$ 428,033</u>	<u>\$ 498,620</u>

Principal payments due in the next three years are as follows:

1998	\$ 102,000
1999	417,201
2000	10,832

8. Share Capital

(a) Authorized

Unlimited number of:

Common shares

First preferred shares, issuable in series

Second preferred shares, issuable in series

The First preferred series A shares had the following rights, privileges, restrictions and conditions:

- holders were entitled to receive, as and when declared by the Board of Directors, cumulative cash dividends at the rate of 9½% per annum, payable quarterly.
- the First preferred shares, Series A, were redeemable at a price of \$1.46 per share plus accrued and unpaid dividends.
- holders were entitled to one vote in respect to each First preferred share, Series A held.

NOTES TO FINANCIAL STATEMENTS

(b) Issued	1997		1996	
	Number of Shares	Amounts	Number of Shares	Amounts
Common shares				
Balance, beginning of year	6,640,013	\$ 5,766,939	3,436,800	\$ 2,250,488
Issued for cash on exercise of options	428,667	699,266	403,213	230,034
Issued for cash via private placement	—	—	400,000	448,000
Issued for cash via private placement (Note 8(e))	600,000	3,600,000	1,200,000	2,400,000
Issued for cash via public offering	—	—	1,200,000	780,000
Issued in exchange for services	10,000	70,000	—	—
Share issue costs	—	(291,897)	—	(341,583)
	<u>7,678,680</u>	<u>\$ 9,844,308</u>	<u>6,640,013</u>	<u>\$ 5,766,939</u>
First preferred shares, Series A				
Balance, beginning of year	—	\$ —	547,945	\$ 756,808
Repurchased and cancelled (d)	—	—	(547,945)	(756,808)
	<u>—</u>	<u>\$ —</u>	<u>—</u>	<u>\$ —</u>
		<u>\$ 9,844,308</u>		<u>\$ 5,766,939</u>

(c) Employee stock options

The Company has established a stock option plan for the benefit of the directors, officers and employees of the Company. Options may be granted to purchase up to 10% of the common shares of the Company at any time at a price of not less than 90% of the current market price as listed on a stock exchange or, if the common shares are not then listed on a stock exchange, the exercise price will be as determined by the Board of Directors of the Company. The Company has granted stock options to certain directors, officers and employees for a total of 522,300 common shares (1996 - 432,180). Pursuant to this stock option plan, 481,000 options were issued in 1997 (1996 - 388,000). In addition 1,000 options were cancelled in 1997. Details of the options outstanding at the date specified are as follows:

As at May 31, 1997

25,000	at an exercise price of \$.85 per share, expiring September, 2000
2,500	at an exercise price of \$1.42 per share, expiring February, 2001
20,000	at an exercise price of \$4.15 per share, expiring May, 2001
42,000	at an exercise price of \$6.50 per share, expiring August, 2001
88,800	at an exercise price of \$6.50 per share, expiring October, 2001
292,000	at an exercise price of \$6.95 per share, expiring November, 2001
17,000	at an exercise price of \$6.25 per share, expiring February, 2002
35,000	at an exercise price of \$5.85 per share, expiring May, 2002

As at May 31, 1996

65,180	at an exercise price of \$.50 per share, expiring April, 1997
125,000	at an exercise price of \$.85 per share, expiring September, 2000
162,000	at an exercise price of \$1.42 per share, expiring February, 2001
80,000	at an exercise price of \$4.15 per share, expiring May, 2001

(d) Contributed surplus

During 1996, the Company repurchased and cancelled 547,945 Series A preferred shares and related cumulative dividends unpaid of \$411,920 (\$380,000 cumulative and unpaid balance to May 31, 1996) for a purchase cost of \$400,000. The cancelled shares were recorded in the financial statements at \$756,808, resulting in contributed surplus of \$356,808.

(e) Warrants and options

- (i) During the current year, the Company issued, on a private placement basis, 600,000 units at a price of \$6.00 per unit. Each unit consisted of one common share and one half of one warrant. Each warrant entitles the holder to acquire one share at \$6.90 per share on or before October 25, 1997. 300,000 warrants were issued and remain outstanding at May 31, 1997.

Additional stock options and warrants were issued to the agent who assisted with the raising of capital for the Company as follows:

- 60,000 stock options were issued at an exercise price of \$6.00 per share. These options remain outstanding as at May 31, 1997 and expire on April 25, 1998.
- 30,000 stock warrants to be issued entitling the holder to acquire one share at \$6.90 on or before April 25, 1998. The agent must exercise all of the above noted options prior to any exercise of these warrants.

NOTES TO FINANCIAL STATEMENTS

- (ii) During the prior year, the Company issued, on a private placement basis, 1,200,000 units at a price of \$2.00 per unit. Each unit consisted of one common share and one half of one warrant. Each Warrant entitles the holder to acquire one share at \$2.50 on or before October 23, 1997. 600,000 Warrants were issued and remain outstanding at May 31, 1997.

Additional stock options were issued to agents who assisted with the raising of capital for the Company as follows:

- 180,000 stock options were issued at an exercise price of \$0.65 per share, of which 13,287 (1996 - 166,713) were exercised during the year.
- 75,000 stock options were issued at an exercise price of \$2.50 per share, of which 25,500 were exercised during the year. The remaining options outstanding as at May 31, 1997 expire in October 1997.

9. Earnings per Share

No provision for preferred share dividends has been provided in calculating the earnings per share for 1997 or 1996 as these shares were repurchased in 1996.

10. Income Taxes

The Company has research and development costs of \$6,056,261 (1996 - \$4,503,245) available to reduce future taxable income and investment tax credits of \$1,553,016 (1996 - \$1,201,274) available to reduce future taxes payable, subject to confirmation by taxation authorities. The research and development cost pool will be reduced by the amount of any investment tax credits utilized. The Company has recognized and accrued \$529,481 (1996 - \$529,481) of investment tax credits on the balance sheet to date.

The future benefits of the net research and development costs carried forward have not been recognized in these financial statements.

Income taxes reported differ from the amount computed by applying the statutory federal and provincial income tax rates to income before income taxes. The reasons for these differences and their tax effects are as follows:

	1997	1996
Provision for income taxes based on statutory tax rate of 44.34%	\$ (606,232)	\$ 54,400
Unrecognized benefit (utilization) of tax loss carry forwards	627,518	(58,089)
Capitalization (utilization) of research and development tax pools	-	-
Utilization of investment tax credits from previous years	-	-
Other	(21,286)	3,689
	<u>\$ -</u>	<u>\$ -</u>

11. Commitment and Contingencies

- (a) The Company is committed under the following leases for the rental of office and manufacturing space, with the aggregate yearly rental under the unexpired terms of these leases as follows:

	Calgary Property	Saskatoon Property
1998	\$ 75,000	\$ 32,307
1999	75,000	32,307
2000	79,167	32,307
2001	85,000	2,692
2002	49,583	—

- (b) A legal claim has been filed against the Company which is currently outstanding. It is the opinion of the Company that this claim is without merit. A reasonable estimate for any potential loss cannot be made. As a result, no provision has been made for this claim in the financial statements. However, should any loss result from the resolution of this claim, such loss would be accounted for in the period in which it occurs.

12. Related Party Transactions

During the 1996 fiscal year certain directors and shareholders of the Company advanced \$427,500 to the Company. A total of \$27,793 (1996 - \$15,689) in interest was paid in relation to this debt (Note 6).

13. Economic Dependence

The Company has entered into an exclusive, long-term teaming agreement with Honeywell Inc., a major supplier of avionics equipment, to develop, manufacture, install, maintain and market the Company's next-generation satellite landing system. The majority of the Company's future sales will be generated pursuant to the terms of this agreement.

14. Financial Instruments

As disclosed in Note 1(g), the Company holds various forms of financial instruments. The nature of these instruments and the Company's operations expose the Company to foreign currency risk, interest rate risk, fair value, and industry credit risks. The Company manages its exposure to these risks by operating in a manner that minimizes its exposure to the extent practical.

NOTES TO FINANCIAL STATEMENTS

(a) Interest rate risk management

The fixed interest rate debt is subject to interest rate price risk, as the fair value of debt will fluctuate as a result of changes in market rates. As at May 31, 1997, the Company had fixed interest rates on approximately \$456,000 of its long-term debt obligations. The remaining \$74,000 of long-term debt is non-interest bearing.

In addition, the Company also has the obligation to pay a specified percentage of future gross revenues as detailed in Note 7.

(b) Foreign currency rate risk management

A significant portion of the Company's accounts receivable and accounts payable is denominated in U.S. dollars. Accordingly, the net amounts outstanding are subject to fluctuations in exchange rates. The Company does not have any exposure to highly inflationary foreign currencies.

(c) Credit risk

A significant portion of the Company's trade accounts receivable are from companies in the avionics equipment industry and as such, the Company is exposed to all the risks associated with that industry.

15. Subsequent Events

- (a) Subsequent to the year end, the Company issued 100,000 common shares for a total of \$250,000 consideration, upon exercise of stock warrants.
- (b) Subsequent to the year end, the Company issued 12,000 common shares for a total of \$30,000 consideration, upon the exercise of stock options.

BOARD OF DIRECTORS

Michael C. J. Beamish
Senior Vice President and Deputy Chairman
Pelorus Navigation Systems Inc.

Edward G. Fitzhenry
Chairman and CEO
Pelorus Navigation Systems Inc.

Shirley A. Fitzhenry
Senior Vice President and Corporate Secretary
Pelorus Navigation Systems Inc.

Terry R. Gibson
President
CWM Investment Management Inc.
Calgary, Alberta

Bruce C. Grant
Partner
Quorum Funding Corporation
Calgary, Alberta

Kenneth C. Lett
President and CEO
Executive Flight Centre Inc.
Calgary, Alberta

David L. Mitchell
President
Kairos Consultants
Calgary, Alberta

Brooke N. Wade
Chairman and CEO
Acetex Corporation
Vancouver, British Columbia

OFFICERS OF THE COMPANY

Michael C. J. Beamish
Senior Vice President and Deputy Chairman

Peter W. Bolton
Vice President Marketing

Edward G. Fitzhenry
President and CEO

Shirley A. Fitzhenry
Senior Vice President and Corporate Secretary

Mark E. Roberts
Vice President Operations

Stan Zwierzchowski
Vice President Engineering and C.O.O.

INVESTOR INFORMATION

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Calgary, Alberta, Canada T2P 3S8

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BDO Dunwoody
1500, 800 - 6th Avenue SW
Calgary, Alberta, Canada T2P 3G3

Bankers
Alberta Treasury Branches
5, 2681 - 36th Street NE
Calgary, Alberta, Canada T1Y 5S3

Stock Exchange
The Alberta Stock Exchange
Symbol "PN"

ANNUAL MEETING OF SHAREHOLDERS

Westin Hotel • 3:00 PM • November 19th, 1997
Calgary, Alberta



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